Q4 2023

TRADING ACTIVITY

BARRANTAGH INVESTMENT MANAGEMENT

Canadian Small Cap Equities

After starting the fourth quarter with negative momentum, risk markets bounded higher to close out the year. Supportive economic data of cooling inflation and signalling from central banks raised prospects for an end to the coordinated interest rate hikes that defined the last eighteen months. Interest rates fell, interest rate sensitive securities got bid higher and a relief rally ensued to end 2023.

The portfolio outperformed the benchmark during Q4 on the strength of industrials (strong security selection), consumer staples (overweight allocation) and financials (overweight allocation). This was partially offset by detraction from materials (underweight, junior miners up strongly).

Despite the welcome lift, it was a challenging year for Canadian small caps. We have written previously about the poor breadth of this market and smaller companies being left behind. Though breadth improved during Q4/23, performance for the year was bifurcated by market cap size. Of the ~460 Canadian equities we track the median return of the top quartile (largest companies) was +12%, second quartile +3%, third quartile +2%, and bottom quartile (smallest companies) -13%. Over the last year, investors in smaller cap equities were battling strongly against this tide.

One example of a small/mid-cap that has persevered against this sentiment headwind is Equitable Group (EQB), which has grown to be the seventh largest Schedule I bank in Canada. The self dubbed "Challenger Bank" outperformed strongly during the year (+57%) versus the bank sector (+9%) and has also significantly outperformed over three years (+22% CAGR versus +11% for bank stocks). Driving these strong returns for shareholders has been outstanding growth in the business. In 2023, EQB delivered double-digit EPS growth and return on equity of 17%, while larger banks fought to hold flat or mitigate declines. EQB navigated the rising rate environment well; their digital first strategy with no physical locations helped them be competitive on costs, while more diversified funding sources and keen underwriting did a solid job protecting net interest margins.

Despite the strong share price performance, EQB's valuation remains undemanding at ~7x forward P/E (in-line with its five-year average), a 30% discount to the Big 6 banks. With its fiscal year-end now aligned with the large banks (easing comparability) and continued execution on mid-teens book value per share growth and ROE, we expect this gap to narrow over the coming years ahead.

The flip side of the lagging performance from small cap equities is the highly attractive opportunity ahead. Looking at current valuations for this same grouping of Canadian stocks the largest group currently trades at a 5% discount to their five-year average, the next largest trades at a 17% discount, the third largest trades at a 20% discount, and the smallest group trades at a 32% discount. Simple mean reversion implies stronger future returns for smaller stocks. Further, as interest rates steady and eventually go lower, this previous headwind on valuation and deal activity will become a tailwind for smaller cap equities and free cash flow growth should reaccelerate driving compounding intrinsic value for our Portfolio holdings.

BUYS

No buys were made this quarter but top-ups were made to: Jamieson Wellness (JWEL), Boralex, (BLX), AG Growth (AFN), Gibson Energy (GEI), Superior Plus (SPB), Cargojet (CJT) and Savaria (SVI).

SELLS

Enerflex (EFX) and DentalCorp (DNTL) were sold with proceeds funding the top-ups made to the above companies which we deemed to have a more attractive risk-reward.

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